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TAGS: ECON EFIN EINV EPET MY

SUBJECT: Not Too Sweet -- Malaysia Economic Update for September 2006

¶11. (U) Summary: Malaysia's inflation rate unexpectedly fell in August from a 7-year high in July, moving real interest rates back into the positive zone again. Bank Negara elected to keep interest rates unchanged and the Bank's governor signaled that the halt in interest rate hikes would likely continue. Meanwhile, Motor vehicle sales fell again in August (the seventh straight decline this year) and Malaysia's self-inflicted sugar shortage continues. End Summary.

Inflation Slows in August

¶12. (U) Malaysia's inflation rate unexpectedly fell to 3.3% year-on-year in August, declining from a 7-year peak of 4.8% in March and 4.1% in July. The significant moderation in the consumer price index (CPI) in August surprised many private analysts who had forecast an average increase of 3.6%. The drop was largely due to lower price levels for food and transportation, which make up 31.4% and 15.9% of the CPI, respectively. For January through August, the CPI increased 3.8% from the same period a year ago.

¶13. The inflation rate is now expected to stabilize at around 3.4% for September to December. Private analysts have adjusted their forecasts to around 3.7% for 2006, as opposed to earlier projections of over 4%. The Ministry of Finance forecasts inflation to be 3.9% for the year. Although there are risks to the inflation outlook due to increased demand during the October holidays of Deepavali and Hari Raya, the government has imposed price ceilings on 15 essential food items, including meat and vegetables, from September 24 to October 31 to keep inflation in check (price ceilings on these items are in addition to price controls on a long list of other normally controlled items). Also, a much talked about hike in the water tariff (which many analysts had predicted would take effect in January 2007) is now likely to be postponed as government officials refuted claims that the water utility company, Puncak Niaga Bhd, had won approval for a water-tariff hike.

Positive Real Interest Rates

¶14. With the CPI declining to 3.3% year-on-year in August, real interest rates in Malaysia are back in the positive zone again. Currently, the benchmark 3-month time deposits rates are earning between 3 to 3.3%, 6-month between 3 to 3.5% and the 12-month between 3.7 to 4%. The last time real interest rates were positive was in June 2005.

Pause in Interest Rate Hikes Continues

15. Bank Negara kept the overnight policy rate (OPR) unchanged at 3.5% following a meeting of its Monetary Policy Committee (MPC) on September 26. This was the fourth time since May that the MPC decided not to raise rates. On September 20, Bank Negara Governor Dr. Zeti Akhtar Aziz said the Central Bank would temporarily halt interest rate hikes and forecast inflation would moderate to 3% in 2007, as there was no demand-pushed inflation. Analysts generally expect the Central Bank to maintain the current OPR for at least the next 6 months. CIMB chief economist Lee Heng Guie said Bank Negara is likely to maintain the OPR at the current level even if the Fed decides to cut rates. Interest rate differentials between the U.S. and Malaysia remain wide at 175 basis points.

Car Sales Dip

16. Meanwhile, Malaysian motor vehicle sales fell 6.4% in August, the seventh straight monthly decline this year. The Malaysian Automotive Association (MAA) said total industry volume last month slowed to 47,189 units against 50,417 in the same month a year ago. However, this was slight improvement over the month of July. The association predicted sales this year would fall to 520,000 units, a 5.6 percent decline from 2005's record sales of 551,042 vehicles.

17. An MAA spokesperson said there had been price uncertainty and confusion in the automobile market following the GOM's announcement of changes to the National Automotive Policy (NAP) on March 22 (when the GOM cut duties on locally made and imported cars in the NAP) and that this had produced a "wait and see" attitude among buyers. Prices for new cars have fallen 1% and trade-in values have fallen 30-40%. The MAA representative said unattractive trade-ins values for second hand cars, coupled with tighter bank financing and higher

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fuel prices, had slowed demand for new cars. An industry source pointed out that about 75% of buyers normally trade in their existing cars when they purchase new ones.

18. Some analysts predict slightly stronger auto sales in the near term because of the upcoming Malaysian festive season, including Eid il Fitri (end of Ramadan), Deepavali, and Christmas. Tempering this, however, are buyers' continuing concerns about lower trade-in values and the need for parents to budget for the new school year. One economist interviewed by EconFSN said he does not think the Malaysian used car market will turn around before 2007.

Scrapping Old Cars for New Car Vouchers

19. In an effort to stimulate new car demand and reduce the inventory of used cars, car industry players have been advocating that the GOM issue vouchers to new car buyers in exchange for their trade-ins that are 15 years old or older, and that the GOM also ease credit financing on autos as well as relax restrictions on the export of reconditioned cars. However, the GOM has said that it needs to study the scrapping policy further to ensure the implementation can be done properly. One car dealer told EconFSN that the scrapping idea was first suggested 10 years ago, but that the current situation in the auto market had made its implementation more urgent.

Banks Urged to Relax Auto Credit

10. Auto lending has become stricter recently because of the increase in loan defaults, and there is speculation that Bank Negara has been tightening auto credit facilities for its member banks in an effort to improve the banks' nonperforming loan ratios. In response to this, Finance Ministry Parliamentary Secretary recently urged banks to relax credit on car loans to address the slowdown in the auto market. The gross ratio of non performing loans on autos currently stands at 4.5%. (Comment: Industry experts have been predicting this turndown in sales. Last year, some banks were providing car loans with durations as long as nine years with no

money down. Anyone with even a half-way reasonable credit rating was able to buy a car. The industry will be paying the price for these incentives for years to come.)

Sugar Shortage Continues

¶11. Malaysia has been experiencing a sugar shortage since April of this year. Analysts believe this shortage is the result of speculation by wholesalers who are betting that the government will eventually be forced to increase the price they can charge for sugar (currently, the government has fixed the price of sugar in Malaysia about 50% lower than in neighboring Singapore), hoarding by consumers concerned about further shortages, and the export of sugar to countries where the price is higher than Malaysia. (Comment: Some analysts believe the speculation in sugar may be tied to the GOM's decision earlier this year to cut fuel subsidies. End Comment).

¶12. Meanwhile, consumers, food stall owners and other small and medium entrepreneurs are suffering. One SME company (a manufacturer of chili sauce and tomato ketchup) told EconFSN that the sugar shortage has had an adverse effect on the company's production by forcing it to cease operations at least one day per week. Econ Counselor observed a discussion between a traveler and a food stall operator in an airport. The traveler wanted to buy a traditional small cake to take on the plane to enable him to break his fast during his flight (Muslim Malays are fasting during this month of Ramadan). The traveler was astounded that the retailer did not have any of this traditional product for sale at this time of year. The food stall operator responded that she wished she did as she was losing business, but she had no sugar to make cakes.

¶13. Concerned by the shortage, Deputy Prime Minister Najib, chairman of the Cabinet Committee on Essential Goods, said the GOM was monitoring the situation and giving time for local sugar manufacturers to keep their promises to increase production. He warned, however, that the GOM would liberalize the sugar market if manufacturers failed to produce enough sugar to supply local needs.

Looking For Ways to Overcome the Situation

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¶13. Commenting on media reports, a Malaysian Muslim Consumers Association (MMCA) official told EconFSN that he believed the sugar monopoly should be disbanded. He also suggested that government-linked companies (GLC) involved in agriculture should be permitted to go into sugarcane production. The country's sugar industry is controlled by 4 private sector producers. Meanwhile, an economist said short term measures could be taken to alleviate the shortage, such as increasing the number sugar licenses for wholesalers and imposing and enforcing stricter regulations on sugar wholesalers. The government has taken one step already, but perhaps not the best one. It recently fixed the previously free price for fine (powdered) sugar at a level comparable to that of coarse (granulated) sugar.

¶14. The MMCA official said there is currently only one company licensed to import sugar, and with only one permit holder, the price of imported sugar can be easily manipulated. He said the GOM should issue additional permits to import sugar and appoint a government agency to monitor sugar imports throughout the distribution and retailing chain.

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